DEPARTMENT OF CORPORATIONS

Testimony of Preston DuFauchard
Commissioner of the California
Department of Corporations
Before the
Senate Banking, Finance & Insurance Committee
Informational Hearing on
"Nontraditional Mortgage Guidance"

January 31, 2007

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Testimony Before The
Senate Banking, Finance and Insurance Committee
Informational Hearing On
"Nontraditional Mortgage Guidance"

January 31, 2007

I. Introduction

Good afternoon Mr. Chairman and members of the Senate Banking, Finance and Insurance Committee. My name is Preston DuFauchard. I am the Commissioner of the California Department of Corporations. I was appointed to this position just over six months ago. Thank you for inviting me to attend this afternoon's hearing.

Joining me today are Louisa Broudy and Tim Le Bas. Louisa Broudy is Deputy Commissioner in charge of the Department's Financial Services Division. That Division is responsible for licensing and regulation of the licensees under both the California Residential Mortgage Lenders Law and the California Finance Lenders Law, among others. Also joining me is Tim Le Bas, Deputy Commissioner, with the Department's Office of Law and Legislation.

For this informational hearing, we were asked to address two issues:

1. First, whether the Department is authorized to implement and enforce the Guidance on Nontraditional Mortgage Product Risks developed by the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR").
2. Second, whether the Department foresees any challenges to implementing and enforcing the Guidance.

The short answer to each of these questions is yes. Let me expand upon that answer briefly.

II. Authority to Implement the Guidance for Nontraditional Mortgages

The laws administered by the Department provide the Commissioner with broad authority to adopt guidelines for those licensed lenders making mortgage loans. For example, the California Finance Lenders Law specifically states that "the commissioner may make general rules and regulations ... for enforcement of this division, in addition to and within the general purposes of this division. " Cal. Fin. Code § 22150. The California Residential Mortgage Lending Act has similar, though less explicit provisions.

These provisions of law authorize the Department to adopt some form of regulation that would require Department licenses to follow the Guidance issued by AARMR and CSBS.

The process for adopting any such regulations is governed by, the California Administrative Procedures Act (the "APA"). The APA sets forth a comprehensive procedure for the adoption of regulations. Our experience indicates it typically takes six months to one year to adopt regulations under the APA, given the various public notice and other formal approval requirements.

In our annual rulemaking calendar that must be prepared by January 30th of each year, the Department has listed the Guidance as a potential rulemaking project during 2007.

III. *Challenges to Implementing and Enforcing the Guidance*

In discussing challenges to implementation I should discuss external challenges to the Department's legal authority, and internal challenges of implementation. As far as external challenges to the Department's legal authority to adopt the Guidance, we are aware of no source for such a challenge.

We do face internal challenges of implementing the Guidance though. The largest challenge is a function of the scope of the Guidance. Much of the Guidance concerns itself with institutional risk management. The federal regulatory agencies that adopted the Guidance are agencies concerned with systemic risks posed by the nontraditional mortgage products; that is they monitor the risks these loans have on the individual member banks, risks posed to the banking system as a whole, and risks to investors who purchase mortgage-backed securities in the market. Even in the way these federal agencies set forth their Guidance proposals, they suggest institutional risk management measures before discussing consumer protection measures.

As such, the Guidance these federal regulators have adopted get at the problems associated with nontraditional mortgages from a slightly different angle than the examination procedures used by the Department of Corporations. The lending laws the Department enforces tend to place the interests of the consumers and fair competition ahead of institutional and risk management systems. Accordingly, in the Department's examinations of the lenders it regulates, the Department tends to place little emphasis on the safety and soundness of loan portfolios as institutional risks. Instead of examining the lenders' risk management procedures, the Department concerns itself with the fairness and transparency of the lending practices, for example, making sure that lenders are not overcharging borrowers in calculating allowable fees.

To be sure, the proposed Guidance contains prescriptions for consumer protections, and we agree that consumers should understand these products more fully, but the Guidance goes much farther than its consumer measures. The Guidance concerns sound underwriting practices and risk management procedures. Accordingly, the examination and enforcement of the FULL set of guidelines may be a bigger pill than the Department can swallow within existing resources.

Adoption of any form of regulation creates an expectation that it will be enforced. The Department would need additional training to develop skills and resources to analyze and enforce underwriting criteria and lender risk management procedures of Department licensees. Unlike my colleagues from Department of Financial Institutions, we do not have bank examiners on staff to assess the safety and soundness of the loans made by our licensees.

For these reasons, we are assessing how to implement the consumer provisions of the Guidance and be flexible on the other provisions.

IV. Conclusion

This concludes my remarks. I want to thank the Chair and the Committee for an invitation to participate in this hearing. The Department and I look forward to working with the Committee. Ms. Broudy and Mr. Le Bas are here today to assist the Committee and its staff, if there are any questions.

Jeff Davi, Real Estate Commissioner

Testimony Before The
Senate Banking, Finance and Insurance Committee
Informational Hearing On
"Nontraditional Mortgage Guidance"

January 31, 2007

Good afternoon Mr. Chair, Senators, I am Jeff Davi, Real Estate Commissioner. Thank you for the opportunity to address the Committee on the issue of Nontraditional Mortgage Products and consumer protection. I have brought with me members of my staff should the committee have any technical questions.

As Commissioner, and as a one-time practicing broker, I have a broad perspective on mortgage lending, the abuses that can occur, and the problems entailed in regulating mortgage broker transactions. I know my time is brief, so instead of providing a description of the Department of Real Estate's (DRE) programs, it's regulatory authority, and available consumer publications, I have brought for each of you a folder of materials that contains, among other things, my written testimony, information about the DRE and pertinent consumer publications.

The committee has asked that I respond to two specific issues, including whether the DRE, which licenses real estate brokers who conduct business as mortgage brokers, has the authority to implement and enforce the guidance issued jointly by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Lenders regarding the origination of non-traditional mortgage programs. The short answer is that I believe the DRE currently has the statutory authority to implement the guidance, <u>at least to the extent the guidance is applicable to real estate brokers who broker loans.</u>

However, I also believe a careful and measured approach for implementing the guidance as it relates to real estate brokers is necessary to ensure the desired outcome of consumer education is achieved. In this regard, I think it would be helpful to provide some background. The Real Estate Law allows brokers to conduct a wide variety of activities, including the listing and sale of real property and mortgage brokering.

In fact, over the past decade or so, mortgage brokers have become a significant player in arranging mortgage loans in California. The great majority of mortgage brokers act as retail channels for banks, thrifts and mortgage bankers. Mortgage brokers generally do not have any latitude regarding the underwriting guidelines on the loans they arrange and have little leeway regarding the rates charged to the borrower. Mortgage brokers typically act as conduits for lenders. Their role is generally limited to originating loans on behalf of lenders and ensuring the loan product offered by the lender is packaged pursuant to the guidelines required by the lender with whom the broker is affiliated or associated. As such, I believe most of the guidance is not applicable to real estate brokers. The guidance does provide guidelines for lenders who accept third party originations, and I believe the guidelines set forth for third party originations are appropriate. There is one portion of guidance, however, that I believe is applicable to mortgage brokers and that is the timely delivery of lender required nontraditional disclosures and how the products are marketed.

With respect to marketing and advertising, existing law requires that real estate brokers disclose all material facts about a product in the ad or materials used to solicit borrowers. In the folder I provided you, you will find the pertinent advertising laws and regulations. In brief, any promotion of a nontraditional mortgage must include the material facts of the product so the ad or promotional material is not misleading. This would include disclosures of the possibility of negative amortization, frequency of payment or rate adjustments, and the amount of the balloon payment if the program is not fully amortized. This is also true of any verbal discussion a broker has with a borrower. The Department has made significant efforts to educate brokers about their responsibilities owed to borrowers, especially when arranging a nontraditional mortgage. These efforts include the publication of a Real Estate Law Book and materials on the mortgage loan advertising requirements, a Mortgage Loan Bulletin and a booklet on mortgage brokering in California, and routine participation in industry educational seminars. We have also made an extensive effort to educate borrowers. In this regard, I would urge you take the time to review the DRE published consumer booklet "Using the Services of a Mortgage Broker" which is also in folder I provided. On pages 11, 12 and 13 it educates a borrower on what questions to ask to ensure an understanding of the loan terms, especially the terms related to nontraditional mortgages. This booklet was first produced over 15 years ago and is updated periodically. The department is currently in the process of updating the booklet again so it more accurately reflects the information in the guidance. The booklet is available at no charge and has been translated into Spanish & Traditional Chinese. It is also available on the DRE's Web site. The updated booklet will be available later this year.

With respect to broker education, the DRE has already begun a series of efforts to further ensure brokers fully understand their responsibilities to inform borrowers of the relative merits and risks of nontraditional mortgages. In the folder, you will find an article that was written by the DRE and published in the November 2005 edition Mortgage Matters, the trade publication of the California Association of Mortgage Brokers. This article is exactly on point of today's hearing – explaining that brokers have a duty to fully explain to a borrower the merits and risks of alternative mortgage programs before the point of document signing. The article also makes the point that real estate brokers have a fiduciary duty to the borrower and as such, must act in the best interest of the borrower. The department is also planning a series of articles that will mirror the message of this article that will appear in Departmental Publications, including the Real Estate Bulletin, the Mortgage Loan Bulletin, and our Web site.

As you can see, the DRE has taken steps to ensure the applicable consumer protection issues in the guidance are followed. However, there is one issue I would like to raise with respect to any requirement that would mandate the use of Nontraditional Mortgage Disclosures. The guidance states many argued that lenders should not be responsible for "overseeing the marketing and borrower disclosure practices of third parties." However, the guidance makes it clear that it is expected that lenders "…should have systems in and controls for establishing and maintaining relationships with third parties" because reliance on third-party relationships can "significantly increase an institution's risk profile." The guidance goes on to state that lender oversight of third party originations should involve the monitoring of the quality of the originations so that it reflects the lender's standards. Presumably, this would include giving the consumer any lender nontraditional mortgage disclosure. This raises practical issues with respect to brokered loans. I think we can all agree the sooner the consumer has pertinent information about the loan the better. General information can and should be given upfront. However, many times when a broker originates a loan, it is not known with which lender the loan is to be placed. If it is mandated that brokers provide Nontraditional Mortgage Loan disclosures before the lender is known, it will create a situation whereby the broker provides a set of disclosures to the consumer only to have the lender provide another set of disclosures with essentially the same information, but only in a different format or style. The redundancy will create more paperwork to an already disclosure and paper laden process and may lead to confusion, indifference or actually dilute the impact of the disclosure. However, I believe a workable solution is possible, and I pledge to work with this committee and its staff, our sister departments, and industry and consumer groups to ensure any necessary change in regulations or policy meets the goal of the guidance.

This concludes my remarks. I want to thank Senator Machado and the committee for the opportunity to speak on this important subject. At this point I would be happy to answer any questions.

California Association of Mortgage Brokers

TO:	Senate Banking, Finance and Insurance Committee
FROM:	Greg Hines, Director of Government Affairs, California Association of Mortgage Brokers
DATE:	January 31, 2007
SUBJECT:	CAMB remarks for Senate Banking and Finance Hearing

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California Association of Mortgage Brokers
Prepared Remarks by Greg Hines, Director of Government Affairs

Mr. Chair, members of the committee, I want to start out today by thanking each of you for the opportunity to participate in today's proceedings. My name is Greg Hines, and I am the director of government affairs for the California Association of Mortgage Brokers (CAMB). It is a pleasure to be here today.

Since its inception in 1990, the California Association of Mortgage Brokers has promoted the highest standards of professional and ethical conduct, among which are expert knowledge, accountability, fair dealing, and service to the consumer and our community. The Association provides education, legislative and regulatory representation, and public relations for its 4,000 plus membership of mortgage brokers and affiliated service providers across California, while serving as a forum for the development of common business interests across the industry.

Non-traditional mortgage products are the driving force for homeownership today in many parts of the country. It was innovation within the mortgage lending industry that led to the development of nontraditional mortgage products and allowed lenders and consumers to work together to combat significantly rising home prices. However, with any new innovation come new issues and complications. While these non-traditional products offer the opportunity of lower monthly payments compared to traditional mortgages, they also come with increased financial risk, consumer responsibility, and more opportunities for the occurrence of abusive lending practices.

CAMB has been at the forefront of promoting "best practices" to advance consumer education and ensure higher ethical and professional standards throughout the mortgage industry. With the successful passage of AB 790 and AB 2890 last year, CAMB has demonstrated its sincere interest to work with our partners in government on this effort, and we believe that similar partnership between government, industry, and consumers is needed to continue to address abusive lending in a comprehensive manner that examines the roles of all involved parties.

Included in the regulatory agency guidelines, were recommendations related to the updating of loan disclosures. We at CAMB wholeheartedly agree with the federal government's goals to educate the consumer in efforts to curb predatory lending, and believe that our members are already practicing much of the prescribed recommendations. CAMB believes it is important to update mortgage informational brochures and key mortgage disclosures to address nontraditional mortgages and make the requirements of those disclosures uniform for all loan originators. Furthermore, we believe any changes need to be consumer-tested in order to determine the effectiveness of those changes.

Updating brochures and other educational materials and writing the material in a way the average consumer can understand will help increase consumer knowledge of all mortgages in the marketplace. Government-required information booklets like the Buying Your Home: Settlement Costs, Helpful Information and the Consumer Handbook on Adjustable Rate Mortgages (CHARM) need to be updated to succinctly explain the potential risks and benefits of these types of loans. Consumer education is a vital tool to protect from unscrupulous lending practices and this information should be available to all consumers, no matter where they come from or where they are buying a home.

Current government-required mortgage disclosures that are designed to ensure consumers are well-informed are based on a mortgage market without the presence of nontraditional mortgage products. Interest-only and payment option adjustable rate mortgages, with their payment variability based on consumer choice, has made government disclosures ineffective in truly disclosing the financial terms, benefits, and risks of a particular loan. Government-required mortgage disclosures like the Good Faith Estimate (GFE), the Truth in Lending Statement and California's Mortgage Loan Disclosure Statements need to be updated to provide consumers with a clear perspective on their loan, the actual costs, benefits and long-term financial risks of a loan under different financial scenarios, including a "worst case" scenario.

While efforts to reform/revise current disclosures is a necessary step, CAMB firmly believes that a government must renew its focus on providing sufficient resources to enforce existing abusive lending laws. Most of the abusive lending practices that occur today are already illegal under current federal and state laws, and increasing enforcement efforts amongst the state and federal regulatory agencies will have a dramatic effect on curbing abusive lending practices in the mortgage industry. We can continue to do what is right for the consumer, through education, updating disclosures and other information, and continuing to teach and practice high ethical standards, but in the end, these efforts will make little difference if adequate resources and energies are not provided to stop the bad actors. Mortgage industry and consumer groups, in their daily interaction in the marketplace, can and should help government agencies target new abusive lending practices as they are identified and help identify bad actors within the mortgage industry.

Above all else however, it is imperative that we all work together to improve consumer education related to the various mortgage products available in the marketplace. To further this goal, CAMB has developed for its membership a "Consumer Education & Protection Worksheet" geared to assist the loan originator in ensuring the consumer is educated on the major types of mortgage loans and, in particular, the loan the consumer has selected. An educated and informed consumer is the most effective weapon to combat abusive lending practices. CAMB truly believes that this will serve as a solid foundation for our effort to improve our industry and our service by promoting new and innovative ways to protect and educate consumers - even in an unstable real estate market.

I want to thank you all again for the opportunity to be a part of this committee's informational hearing today, and I look forward to continuing our work together to advance consumer education efforts throughout the industry.

CALIFORNIA ASSOCIATION OF MORTGAGE BROKERS (CAMB) CONSUMER EDUCATION AND PROTECTION WORKSHEET

Helping Borrowers Select Their Best Mortgage Fit

Buyer Name: ______

Address: ______

Telephone: ______ Email: ______

The objective of this worksheet is for the prospective borrower and broker to have an educational dialogue that enables the borrower to make an informed mortgage decision and empowers the broker to fit the borrower to the best possible loan. The broker and borrower should take ample time to review and discuss each section thoroughly, and the broker should answer every question so the borrower has the support and information to make an educated decision.

I. BORROWER'S GOALS

What are the borrower's goals and reasons for this financing?

- Are you purchasing ______ or refinancing ______?
- If refinancing, why? ______
- What is most important to you about this mortgage? What is your financial goal? ______
- Rank the following in order of importance (1 being most important, 4 being least important)
- Payment amount______ Loan Amount ______
  - Cost ______
  - Interest rate ______
  - Down payment amount ______
- How long do you intend to live in the home? ______
- Will you be saving for educational expenses? ☐ Yes ☐ No
- Will you be saving for retirement? ☐ Yes ☐ No
- How many years before you plan on retiring? ______
- Will you consolidate debt? ☐ Yes ☐ No
- Discussion on priorities: ______

II. BORROWER'S CURRENT FINANCIAL STATUS

Consider your current outstanding debts, employment outlook and other financial factors.

- Credit score ______
- Source/Date of Score ______
- Total amount of consumer credit debt:
- Attach a list of credit if applicable
- My gross monthly income is $ ______
  Decline to State: _____ Initial: _____
- Can you verify your income? ☐ Yes ☐ No
- Can you verify all sources of funds? ☐ Yes ☐ No
- Can you verify all your assets? ☐ Yes ☐ No
- Income and Employment History: ______
- How much monthly housing expense are you comfortable with, including property tax and insurance?______
- Estimated debt to income ratio: housing ______, total debt ______.

III. BORROWER'S LOAN AMOUNT ESTIMATE

The goal of this section is to estimate how much you can afford to borrow. Compare what you can afford with what you want to buy and what you will be comfortable spending:

- How much money are you able to invest in a down payment, if any? $______
- Are you going to borrow money to make a down payment, and if so, from where? ☐ Yes ☐ No

IV. PRE-APPROVED vs. PRE-QUALIFIED MORTGAGE

Pre-approved consists of credit and application review by an underwriter and a written approval from the lender for a specific loan amount. Pre-qualified consists of a verbal conversation with a broker who provides an estimate of the amount you qualify to borrow.

- Are you pre-approved or pre-qualified for a mortgage? ☐ Yes ☐ No
- For how much:$ ______
- Type of loan ______

V. 60 MONTH ANALYSIS

The goal of this section is to project to the best of your ability where you will be financially in the future. Keep in mind any potential expected changes in your financial standing:

- In the next 2-5 years, I estimate my income to be: $ ______
- In the next 10 years, I estimate my income to be: $ ______
- Do you expect the size of your family to increase or decrease in the coming years?______
- Other financial considerations such as retirement, job location, college education (attach separate list if needed): ______

VI. MORTGAGE OPTIONS

Following are available mortgage options. The broker will provide an overview, including advantages and disadvantages, of the appropriate program(s). Both the borrower and the broker should initial, indicating you, the borrower understand what was explained.

Advantages / Disadvantages

- Arm v. fixed (5 year, 30 year, 40 year, 50 year, other)
- Hybrid v. fixed (5 year, 30 year, 40 year, 50 year, other)
- Interest Only Loans
- Monthly Payments
- Principal Balances
- Pick a Payment
- How each loan/payment works
- Does my payment fluctuate and when will it fluctuate?
- How long will it take to build equity?
- How long to pay off my loan?

Borrower:______ Broker:______

VII. MORTGAGE LOAN DISCLOSURE

Review with your broker the federal and state disclosure forms ("Truth in Lending" and "Mortgage Loan Disclosure Statement") regarding the costs of the mortgage.

- Did you read and understand the Truth in Lending form? ☐ Yes ☐ No
- Did you read and understand the Mortgage Loan Disclosure Statement ☐ Yes ☐ No

VIII. BROKER RECOMMENDATION

The goal of this section is to list the recommended program. There is no guaranteed approval for a loan because of other information that may not be known at this time.

- The recommended program: ______
- Purchase Price: ______
  Down Payment: ______
- Loan Amount: ______
- Fully Indexed Rate: ______
  Payment Rate: ______
  Term: ______
- Adjustment Period: ______
  Index: ______
  Margin: ______
- Life Interest Cap: ______
  Per Adjustment Cap: ______
  1st Adjustment: ______
- Fees: ______
  Other: ______
- Why this option is recommended: ______
- Additional explanation: ______
- Borrower's initials: ______(Borrower understands the terms)

IX.. BORROWER'S DECISION

List reasons why the borrower chose this program and if it differs from what was recommended:

- Decided on______ as the best option
- If the option differs from the broker's choice, list reasons why a different option was chosen: ______

X. COMMENTS

Additional comments and borrower feedback.

- After counsel, borrower chose to ______, not to ______ accept my recommendation.
- Additional Comments: (Why You Chose or did not choose the recommendation) ______
- Borrower feedback: ______

Broker's Signature: ______

Borrower's Signature: ______

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TESTIMONY BEFORE THE SENATE BANKING COMMITTEE INFORMATIONAL HEARING ON NON-TRADITIONAL RESIDENTIAL MORTGAGE PRODUCTS

January 31, 2007

Good afternoon, Chairman Machado, Members of the Banking Committee, Ladies and Gentlemen. My name is George Eckert. I am a licensed real estate broker, part owner of The Money Brokers, Inc., a Sacramento based mortgage loan brokerage. I make my living making mortgage loans. I am Chairman of the Legislative Committee of the California Mortgage Association and am appearing on their behalf. I have previously submitted a written copy of my remarks to the Committee secretary.

The California Mortgage Association is a trade association with more than 400 members, most of whom are DRE licensees engaged in the business of private mortgage finance. Our borrowing clients are typically credit challenged, income impaired, or otherwise unable to qualify for even sub-prime loans. What most of our borrowers have in common is equity and a need for money in a hurry.

Our loans are funded almost exclusively by private lenders, not Fanny Mae, Freddy Mac or some big Wall Street Syndicate. Most often, these lenders are our friends, neighbors and business associates. We offer an alternative to traditional investments such as CD's, stocks, bonds and mutual funds, to investors seeking a higher yield with the relatively low risk of a real estate secured investment.

Our typical investor is an older individual with modest savings, retired or saving for retirement, with little tolerance for risk. This investor profile requires us to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of the borrower's repayment capacity, one of the stated goals of the Interagency Guidance. Loan-to-value ratios are lower than for traditional and most sub-prime loans, typically 70% or less, providing a cushion for market downturns. Credit scores, while considered, are given less weight than a common sense analysis of the borrowers' willingness and ability to pay.

In our industry if you put an investor in a loan that pays on time and offers a nice return you might get a "thank you" and maybe a referral to a friend or neighbor. Put that same investor in a loan that results in foreclosure or a loss and he'll tell everyone who will listen that you are the scourge of the earth. Then he'll sic his lawyers on you and eat you for lunch. Long-term survival in the private mortgage finance industry requires prudent underwriting, first and foremost. We don't need any Interagency Guidance to tell us that.

Typical terms for loans originated by CMA members include interest-only payments, balloon payments and prepayment penalties, but full disclosure of all of these terms is made pursuant to existing laws such as Truth-in-Lending, Regulation Z, RESPA, as well as pertinent provisions of California's Financial Code and Real Estate Laws and Regulations. Fixed rates are the norm but ARM's and Step-Rate loans are not uncommon. Our members don't originate loans with low teaser rates or negative amortization, however, because our investors wouldn't buy them. With our members' loans, what you see is truly what you get.

CMA supports full disclosure of every material loan term as long as such disclosure is meaningful and does not become cumulatively overwhelming for the borrower. To prevent disclosure overload throughout the loan process, and especially at loan closing, we would support coordination of any new disclosures with existing disclosures required by State and Federal law. A streamlining of all relevant disclosure forms to eliminate duplication and minimize overload would be ideal. Model forms that provide lenders with a safe harbor if used properly would be preferred to a do-it-yourself approach with uncertain legal effect.

As an industry, we have been meeting the needs of borrowers and lenders for more than 30 years. We have responded to the challenges of increased regulatory oversight, increased competition, and an ever-changing market for our products. We have survived market run-ups and downturns. We believe our industry provides valuable services to an underserved client base. We would encourage this Committee to seriously consider the potential impact of any proposed legislation on our ability to continue to serve the needs of California's borrowers and private lenders.

Thank you for your time and your attention.

George M. Eckert
Chairman, Legislative Committee

CENTER FOR RESPONSIBLE LENDING

Testimony of Paul Leonard
California Director, Center for Responsible Lending
California Senate Banking Committee
Informational Hearing on Nontraditional Residential Mortgage Products
January 31, 2007

Thank you for the opportunity to testify today and for holding these hearings on such important matters. I am here representing the Center for Responsible Lending (CRL), a national nonprofit, nonpartisan research and public policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL has recently opened an office in Oakland, California to complement offices in Durham, NC and Washington, DC. CRL is an affiliate of Self-Help, one of the nation's largest community development financial institutions. Self-Help has provided more than $4 billion in financing to almost 45,000 homeowners, small business owners and nonprofits across the nation.

In my testimony, I'd like to cover four main points.

- **California families are losing their homes because of risky loan products and loose underwriting in the subprime market.** Much of the explosive growth in the subprime mortgage market in recent years has been driven by loose underwriting standards and the aggressive marketing of high-risk non-traditional loan products. We project that more than one in five subprime loans originated in California in 2006 will end in foreclosure, and *one in three borrowers* with subprime loans will lose their homes. While foreclosures on subprime loans will generally increase all over the country, California will be hit harder than any other state, with many metro areas experiencing the highest projected foreclosure rates in the nation.

- **Applying the federal interagency guidance to <u>all</u> California lenders and brokers is the first step in a return to sound lending principles.** The federal interagency guidance issued last fall returns the mortgage industry to more sound lending practices, including a determination that lenders must maintain their longstanding responsibility to assess whether a borrower can afford to repay a loan based on their income. California should adopt this guidance and extend it to cover state-chartered non-depository mortgage lenders and mortgage brokers.

- **California's guidance should explicitly cover subprime 2-28 and 3-27 hybrid adjustable rate mortgages (ARMs), which include many of the same risks as other loan types directly addressed by the federal guidance.** Although lenders are attempting to minimize the risks associated with subprime 2/28 and 3/27 mortgages, the facts speak for themselves. For example, the most recent Mortgage Bankers Association National Delinquency Survey found that subprime ARMs—primarily composed of

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2/28s—are entering into delinquency at more than four times the rate of prime ARMs and into foreclosure at more than seven times the rate of prime ARMs.[1]

- **The guidance does not go far enough. Additional changes are needed to ensure that homeownership is sustainable for subprime borrowers.** The federal and Conference of State Bank Supervisors (CSBS)/American Association of Residential Mortgage Regulators (AARMR) guidance does not go far enough in protecting subprime borrowers from abusive lending practices. For example, we recommend that all borrowers in the subprime market have their income verified by tax returns, payroll receipts, bank records or other reasonable alternative verification methods. We also recommend that all lenders establish escrow or impoundment accounts on subprime mortgages to pay for property taxes and hazard insurance. Such basic precautions—which are the norm for the prime market and which responsible lenders have practiced for years—will help ensure homeownership is sustainable for vulnerable borrowers.

The need to act is urgent. Home losses caused by high-risk ARMs in the subprime market have already reached alarming proportions, and with the downturn in the housing market, foreclosures will certainly rise further. As described in the remaining testimony, non-traditional mortgages, including exploding ARMs, in the subprime market are actually acting to reverse the traditional benefits conveyed by mortgages, leaving vulnerable families worse off rather than giving them the opportunity to become more financially secure.

I. California families are losing their homes at record rates because of risky loans and loose underwriting standards.

Over the last ten years, there has been an explosion in the availability of mortgage credit for low- and moderate-income families who have less-than-perfect credit. In 2005, subprime originators nationwide made 4.2 million loans totaling $671.8 billion.[2] The volume represents a twenty-fold increase since 1994 and a doubling just since 2003. One in every five home loans originated in 2005 was a subprime loan, growing to nearly one in four through the first three quarters of 2006. The sector has $1.2 trillion of mortgages currently outstanding.[3]

Over just the last few years, the rise in subprime products, that include one or even multiple features that add risks, coupled with relaxed underwriting standards, have placed many subprime borrowers at undue risk of failure and foreclosure. A recent CRL analysis projects that 21.4 percent of all subprime loans initiated in California in 2006 will result in foreclosure. Taking into account the rates at which subprime borrowers typically refinance from one subprime loan into another, this translates into foreclosures for *more than one-third of subprime*

[1] National Delinquency Survey, Mortgage Bankers Association (for the third quarter of 2006), December 13, 2006, as reported in MBA Policy Paper Suitability—Don't Turn Back the Clock on Fair Lending and Homeownership Gains, January, 2007, p. 25.
[2] *See* National Mortgage News Quarterly Data Reports, Quarters 1-4, 2005.
[3] Inside B&C Lending, 9/1/2006; *See also* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006

borrowers.[4] Our analysis found that California subprime borrowers face particularly large risks: nine of the 15 metro areas with the highest projected foreclosure rates for subprime loans originated in 2006 were in California. Similarly, when we looked at subprime loans originated in1998-2001 and compared their projected foreclosure rates with projected rates for subprime loans originated in 2006, California metro areas had the top 14 largest increases in home losses.

Further, these loans will have a particularly damaging impact on communities of color, where there is likely to be a high concentration of foreclosures. According to the most recent HMDA data for 2005, 37 percent of African-American and 35 percent of Latinos were higher rate borrowers in California. By contrast, only 14 percent of white, non-Latino borrowers had higher-rate loans.[5] The impacts on minority communities are even more concentrated in California's urban neighborhoods. The California Reinvestment Coalition recently found that in most large cities in California, more than half of African-American and Latino purchase borrowers received subprime loans in 2005.[6]

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Subprime lenders have been able to substantially insulate themselves from the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has largely removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates in the subprime market have simply become a cost of business that is passed onto borrowers and sometimes investors.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced subprime foreclosure rates far higher than predicted, and in some instances have demanded the repurchase of bad loans where these practices were not adequately disclosed to investors. In a few highly publicized cases, lenders have been forced out of business in recent weeks as a result. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender, which recently filed for bankruptcy protection after investors asked it to buy back *well over one hundred million dollars worth* of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other subprime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[7]

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[4] Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* Center for Responsible Lending, December 19, 2006. Available at www. responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31214551.

[5] CRL analysis of HMDA rate-spread loans.

[6] Kevin Stein, *Who Really Gets Higher-Cost Home Loans? Home Loan Disparities By Income, Race and Ethnicity of Borrowers and Neighborhoods in 14 California Communities in 2005,* December 2006 California Reinvestment Coalition.

[7] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages,*" New York Times (Fri. Jan. 26, 2007) C1, C4.

This greater scrutiny of subprime loans by investors may force lenders to make fuller disclosures to investors or eventually curb some practices, but these changes will be too late for borrowers, who are already losing their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

The dominant product in the subprime market for the last few years has been an adjustable rate mortgage called a "2/28" where the monthly payment increases every six months as the interest rate adjusts upwards after an initial two-year fixed-rate period expires. The initial fixed rate is typically a deeply discounted "teaser" rate, followed by a large rate adjustment that can lead to a significantly higher payment. Because of the resulting payment shock, these loans are sometimes referred to as "exploding ARMs." Hybrid ARMs made up 81 percent of the subprime sector's securitization in the first half of 2006, up from 64 percent in 2002.[8] As discussed in more detail below, at the end of the introductory teaser rate on an ARM, borrowers face a large jump in costs, even if interest rates remain constant.

A lender's failure to account for the incredible payment shock that most borrowers with an exploding ARM will face is compounded by three other practices: failure to escrow property taxes and hazard insurance, limited documentation of income, and the frequent inclusion of prepayment penalties.

II. Recent federal interagency guidance represents a return to sound lending principles and should be applied to all lenders and brokers.

The federal interagency guidance issued last fall returns the mortgage industry to more sound lending practices, including a determination that lenders must maintain their longstanding responsibility to assess whether a borrower can afford to repay a loan. The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have proposed model guidance for states to adopt to cover state-regulated mortgage lenders and brokers. The Center for Responsible Lending strongly supports California moving quickly to enact this guidance, with sufficient authority to fully enforce its provisions.

In September, 2006, federal banking regulators issued guidance on non-traditional mortgages that requires depository institutions (such as banks and federal credit unions) and their affiliates to tighten credit standards for certain non-traditional loans such as interest-only and payment option ARMs. In the simplest terms, this guidance forbids banks from using artificially low "teaser" rates to qualify borrowers, and it also addresses concerns about negatively amortizing loans (when loan payments do not result in lowering the principal amount owed) and approving loans without adequately documenting the borrower's income. Specific provisions of the guidance include:

- **Evaluation of borrower's ability to repay the debt** by the end of the loan term based on the fully indexed rate, (i.e., the current rate of the <u>index</u> associated with the loan *plus* the <u>margin</u> that is added to the index rate) and assuming a fully amortizing repayment

[8] In the 2nd quarter of 2006, 80.7% of subprime loans were adjustable rate loans. This figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006

schedule (i.e., a payment schedule that reduces the outstanding balance to $0 by the end of the loan term).

- **Underwriting based on income, not the value of the collateral.** Institutions should avoid using loan terms and underwriting practices that may heighten the need for the borrower to sell or refinance the property when payments increase.

- **Mitigating factors for risk layering.** When risk features are layered (for example, an interest-only loan with reduced documentation or a simultaneous second-lien loan), the institution should demonstrate that mitigating factors support the underwriting decision and the borrower's ability to repay.[9]

- **Increased documentation of income.** The guidance urges providers to more diligently verify and document a borrower's income as credit risk increases and indicates that providers should only use stated income if there are mitigating factors that minimize the need for direct verification. The guidance also urges providers to document income using W-2 statements, pay stubs or tax returns.

On November 14, 2006, CSBS and AARMR issued model guidance that is substantially equivalent to the federal guidance but is intended to apply to state-regulated mortgage companies and state-licensed mortgage brokers. As of January 26, 2006, mortgage regulators in 24 states have taken some action to adopt the guidance. California's regulators -- including the Department of Corporations and the Department of Real Estate and the Department of Financial Institutions – have not yet taken any action to adopt the CSBS guidance.

The Center for Responsible Lending strongly believes that California regulators must move quickly to adopt and enforce the CSBS/AARMR guidance. If necessary, California regulators should be directed to enforce the provisions of the guidance and it should be clarified that they are authorized to do so. There are three compelling reasons why the guidance should be applied to all state-regulated non-bank mortgage lenders and brokers

First, unlike depository institutions, non-bank mortgage lenders and mortgage brokers are not subject to safety and soundness oversight by the federal banking agencies. Thus, while banks receive guidance and supervision from federal regulators on practices that may entail excessive risk, non-bank lenders and brokers do not. This is a particular concern in markets like the current one, in which competitive pressures have pushed lenders to lessen their underwriting requirements and abandon traditional standards of sound lending.

As the proposed guidance and other regulators have recognized, throughout the market, lenders and brokers have extended loans with less stringent income and asset verification requirements, and without adequate regard to the borrower's ability to repay from sources other

[9] Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance, or other credit enhancements.

than the sale or refinancing of the mortgaged property.[10] With respect to non-bank lenders and brokers, most subprime consumers will be unprotected without guidance from the states.

Second, the non-bank lenders and brokers originate the large majority of subprime mortgage loans. It is critical that there is a level playing field and that subprime borrowers receive the same protections as prime mortgage borrowers. CRL analysis of 2005 Home Mortgage Disclosure Act (HMDA) data shows that 69.4 percent of first-lien subprime home loans in California were made by non-federally-supervised lenders that reported their data to the U.S. Department of Housing and Urban Development (HUD).[11] Mortgage brokers accounted for 59.3 percent of subprime originations nationwide in 2005.[12]

Worse, many borrowers who receive subprime loans could have qualified for a more affordable and responsible product in the first place. Freddie Mac, for example, has publicly commented that one in five subprime borrowers in recent years could have qualified for a lower-cost conventional loan.[13]

Third, the nature of the California's regulators' supervisory authority over non-depository institutions differs from the federal agencies' authority over banks, and suggests the wisdom of adding statutory authority to ensure that the regulators have sufficient authority to enforce the provisions of the guidance. Non-depository lenders and brokers should be put on notice that failure to follow the guidance will be deemed a violation of the California lending and consumer protection laws and will result in disciplinary action as is appropriate.

III. California's guidance should explicitly cover subprime 2-28 and 3-27 hybrid adjustable rate mortgages (ARMs), which include many of the same risks as other loan types directly addressed by the federal guidance.

While interest-only and payment option ARM loans are clearly of concern, the even more common 2/28 and 3/27 subprime mortgages pose a significant risk to families and the industry as

[10] *See* Reuters, *Bies Says Lenders Should Tighten Standards* (Jan. 11, 2007) ("Many industry observers believe the poor performance of more recently originated subprime loans is due primarily to looser underwriting standards, including limited or no verification of borrower income and high loan-to-value transactions," Bies said. She added that lenders need to be "specially diligent" when making such loans."), available at http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=OBR&Date=20070111&ID=6335528.

[11] CRL analysis of Home Mortgage Disclosure Act data. The HMDA regulations applicable to loans originated in 2004 required lenders to report the difference between an originated first-lien home loan's annual percentage rate and the yield on U.S. Treasury securities of a comparable term if that difference was greater than or equal to three percentage points and the loan was subject to the Truth-in-Lending Act. This new reporting field was developed specifically to allow observers to understand subprime lending patterns. However, there is some evidence that this measure may still underestimate the proportion of subprime loans. For more information, see Avery, R.B., G.B. Canner and R.E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (Federal Reserve Bulletin, Washington, DC), Summer 2004 at 344-394, available at http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf.

[12] *Brokers Flex Their Muscle in 2005, Powering Record Subprime Year*, INSIDE B&C LENDING (Bethesda, MD), Mar. 17, 2006. When a reporting institution makes loans through a mortgage broker, the institution rather than the broker reports the HMDA data. *A Guide to HMDA Reporting: Getting It Right!* (Federal Financial Institutions Examinations Council Jan. 1, 2004), at 6.

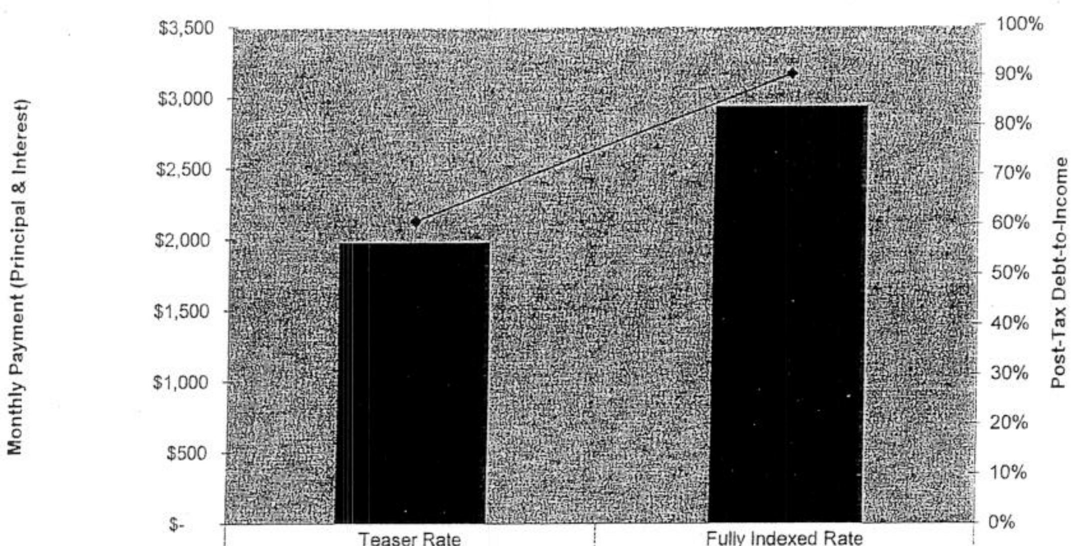
[13] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005).

a whole. The low starting interest rate virtually assures the payment will rise significantly when the rates reset, even if interest rates remain constant and do not rise at all. California should expand its guidance to cover subprime 2/28 and 3/27 hybrid ARMS.

A. How 2/28s and 3/27s Work

Let me provide an example of the severity of payment shock that can occur on the typical exploding ARM:

Subprime Adjustable Rate Mortgage Payment Shock
(No Change in Interest Rates)



	Teaser Rate	Fully Indexed Rate
Monthly Payment	$1,966	$2,921
Post-Tax DTI	61%	90%

For the 2/28 ARM shown in the chart, we made conservative assumptions that correspond with typical mortgages of this type. Further, we have assumed no increase in interest rates generally, even though rates have risen steadily over the last year. The chart assumes an introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent. We assumed that the loan amount was $300,000, and, given the common practice of extending loans where the post-tax debt-to-income ratio exceeds sixty percent, we assumed that this borrower had a pre-tax income of $47,179, which translates to a post-tax income of $38,852.

At the end of the introductory rate period, this borrower's interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped over $600 -- from $1,966 to $2,574, and increased again six months later to $2,921.[14] This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At $2,921, this leaves only $391/month for all other expenses – including property taxes and insurance, food, utilities, transportation, healthcare, and all other family needs.

[14] Typically the rate increase at the first adjustment is capped at three percentage points. On this loan, the rate reached the fully indexed rate at the second adjustment two-and-a-half years into the loan.

Sadly, and all too commonly, this hypothetical borrower had credit scores that would have qualified her for a fixed rate loan at 7.5 percent, which would have translated to monthly payments of $2,097 – a challenging debt-load for sure, but far more sustainable than the $2,921 fully indexed monthly payment associated with this 2/28.

Lenders and brokers who push 2/28 hybrid ARMs often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate and monthly payment will rise significantly. For example, as recently as 2005, a prospectus shows that a large subprime lender, Option One, was underwriting to *the lesser of* the fully indexed rate or one percentage point over the start rate.[15] For a loan with a typical 2/28 structure, the latter would always apply. This practice means that at the end of the introductory teaser rate on an ARM, borrowers face a shocking increase in monthly payment even if interest rates remain constant.

Similarly, as summarized in a November 2006 release, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. Other borrowers have their ability to repay screened at the initial interest rate. Other large subprime lenders are qualifying borrowers at the initial start rate or other standards that do not adequately address the built-in payment shock of these loans.[16]

B. The Case for Extending the Guidance to 2/28s and 3/27s

The CSBS guidance will address some of the abuses in the subprime market by reaching non-traditional subprime mortgages, but it needs to go further. The steep payment shocks on subprime 2/28 and 3/27 hybrid ARMs that follow from dramatic scheduled increases in the interest charges just two years into the loan represent precisely the sort of "deferral of interest" addressed by the proposed guidance. In the case of subprime 2/28 hybrid ARMs, the change in interest rates is typically so large at year two that these terms may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[17] Federal Reserve

[15] See Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

[16] *See* Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) available at: http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm;
Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm ;
Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007) available at: http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm;
Best Practices Won't Kill Production at New Century, p. 3 Inside B&C Lending (November 24, 2006)

[17] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Guidance should require that

Board Governor Susan Bies reached a similar conclusion, recently stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[18]

In addition to being consistent with the notion that these subprime hybrid ARMs present a deferral of interest, this quote also illustrates a second dimension on which subprime ARMs tend to differ from their prime counterparts. Specifically, low introductory rates on subprime ARMs are typically associated with high up-front financed fees whereas fees on prime ARMs tend to be much lower.[19] In other words, subprime ARMs routinely find borrowers trading equity in exchange for dramatically lower interest payments—in essence, an exercise in negative amortization.

Moreover, the magnitude of interest deferral is significantly larger in subprime hybrid ARMs than typically found in prime ARMs. For prime loans, the typical adjustment does not occur for five years and the margin added to the interest rate index is usually between 200 and 400 basis points. Moreover, prime loans are usually adjusted annually, and can generally fall below the initial interest rates. For subprime loans, interest rates usually cannot fall below the initial rate, meaning that they can only go up, not down and generally occur within two or three years. Subprime margins, are usually larger than for prime loans, meaning that the rates will generally rise 5-7 points above the interest rate index. And while most subprime loans do usually limit the amount of increase that will occur at any re-set, interest rates are generally adjusted every six months, rather than annually for prime loans.

Other federal policy-makers have concluded that the guidance should be extended to 2/28 hybrid ARMs. Federal Deposit Insurance Corporation Chair Sheila Bair recently announced that federal regulators are strongly considering issuing a clarification to the federal guidance clarifying that the 2/28 hybrid ARM "certainly was intended to be within the spirit of the alternative-mortgage guidance."[20] This was reinforced by a recent letter from six United States Senators to all of the federal regulators and the CSBS expressing the view that "these [2/28] mortgages have a number of the same risky attributes as the interest only and option-ARMs and, therefore, should be covered by the new guidance."[21]

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lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[18] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[19] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 2007) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06ARMsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp57 1533 (2004).

[20] Joe Adler, *In Brief: FDIC May Treat 2/28s Like Other Exotics*, American Banker, November 15, 2006, vol. 171, no. 220,; Patrick Rucker, *U.S. bank regulators eye new mortgage guidance*, January 10, 2007.

[21] December 7, 2006 letter from U.S. Senators Paul S. Sarbanes, Wayne Allard, Christopher J. Dodd, Jim Bunning, Jack Reed, and Charles Schumer to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner.

While additional federal action to include subprime 2/28s and 3/27s may be forthcoming, there is no reason for California to wait to provide adequate protections to subprime borrowers here. California regulators should act swiftly to provide adequate protections for vulnerable subprime borrowers.

IV. Stronger Protections are Needed to Protect Subprime Borrowers

The federal interagency and CSBS/AARMR guidance establish some useful protections for borrowers and should be adopted uniformly to provide equal protections regardless of the channel from which a borrower gets a loan. As we have noted above, we believe that the protections must be extended to subprime hybrid ARMS, which are equally risky and more common than other non-traditional mortgages.

Subprime lending is based on the notion that borrowers with less-than-perfect credit are greater credit risks and should thus be charged an interest premium to cover this greater risk. We endorse this fundamental concept. But these more vulnerable borrowers who already struggle with debt should not be subject to multiple features – such as lack of escrows, reduced income documentation, onerous prepayment penalties –that separately and together increase the risk that they will be unable to repay their mortgages. Additional protections should be provided to subprime borrowers.

A. Mandatory Escrow/Impoundment for Subprime Loans

Lenders' and brokers' failure to account for the payment shock is compounded by the failure to escrow property taxes and hazard insurance. In contrast to the prime market, where it is common practice to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay, most subprime lenders and brokers sell loans based on low monthly payments that do not take taxes or insurance into account. According to industry sources, only one in four subprime loans includes an escrow or impoundment account for property taxes and hazard insurance payments.[22]

This deceptive practice gives the borrower the impression that the payment is affordable, when in fact there are additional costs that the borrower will likely need to finance. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55 percent of their pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance virtually guarantees that a borrower will not have the residual income to absorb a significant increase in their mortgage payment after two years.

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[22] *See, eg.,* " B&C Escrow Rate Called Low" *(February 23, 2005) Mortgage Servicing News Bulletin, July 23, 2005* "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments....Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

We recommend that California's proposed guidance include the requirement that lenders escrow for property taxes and insurance, and include these payments in the calculation of the borrower's ability to repay the loan.

B. Mandatory Verification of Borrowers Income

The guidance urges lenders and brokers to more diligently verify and document a borrower's income and debt reduction capacity using W-2 statements, pay stubs, or tax returns. This would begin to reduce inflated income statements common with so-called "no doc loans," which are used by subprime lenders and brokers to obscure unacceptably high debt-to-income ratios. Fitch recently noted that, "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector."[23]

In reviewing a sample of "no doc" loans, the Mortgage Asset Research Institute recently found that *over 90 percent exaggerated income* by 5 percent or more and almost 60 percent exaggerated income by over 50 percent. The MARI report notes, "When these loans were introduced, they made sense, given the relatively strict requirements borrows had to meet before qualifying. However, competitive pressures have caused many lenders to loosen these requirements to a point that makes many risk managers squirm."[24]

And brokers succumb to similar pressures, finding ways to approve borrowers when there is not enough income to support paying the loan. A survey of 2,140 mortgage brokers (constituting a national sample) found that forty three percent of brokers who use low document loan products know that their borrowers "can't qualify under standard [debt-to-income] ratios."[25]

We urge California regulators to go beyond the provisions of the CSBS guidance to require that for all subprime loans, lenders or brokers verify all sources of income using tax returns, payroll receipts, bank records and any other reasonable third-party verification methods.

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[23] *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 4.

[24] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *See also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid ARMs "poses a significant challenge to subprime collateral performance in 2007."

[25] "How Mortgage Brokers View the Booming Alt A Market," survey conducted by Campbell Communications cited in Inside Mortgage Finance . Volume 23, Number 42 (November 3, 2006 available at http://www.imfpubs.com/issues/imfpubs_imf/23_42/news/1000004789-1.html and cited in Harney, Kenneth, *"The Lowdown on Low-Doc Loans,"* The Washington Post 11/25/2006 page F-1 (November 25, 2006), available at **http://www.washingtonpost.com/wp-dyn/content/article/2006/11/24/AR2006112400503_pf.html**

C. Prepayment Penalties Either Strip Equity or Trap Borrowers in Subprime Loans

The general inclusion of prepayment penalties in subprime mortgages further compounds the problems of exploding ARMS. Approximately two-thirds of subprime loans also include a prepayment penalty,[26] a penalty for paying the loan off before a certain period, trapping the borrower in the loan when they might be able to refinance into a better product. A borrower who concludes that they would be better off to escape a subprime hybrid ARM (before the rate reset makes it unaffordable) and shift into a fixed rate product, for example, must sacrifice significant equity to pay off the penalty. Prepayment penalties are particularly damaging in California both because of high housing costs and because the standard prepayment penalty is calculated based on six months of interest. This formula, for example, can easily result in a prepayment penalty on a $300,000 loan at 8% interest in excess of $9,000.

We urge California to adopt provisions limiting prepayment penalties on subprime loans to 3 percent for the first year and 2 percent the second year. Prepayment penalties should also be prohibited to extend beyond the date of the initial resetting period of a subprime hybrid ARM.

Conclusion

Until recently, homeownership has served as a lifeline for families to gain security and financial stability, but high-risk nontraditional mortgages are seriously eroding the traditional benefits of owning a home. As we have shown here, the problems are not confined to interest-only and option ARMs. Subprime hybrid ARMs can actually be worse and would disproportionately harm communities of color. Through hybrid ARMs, families in the subprime market are essentially receiving temporary unstable financing. Even if market interest rates do not rise, these loans can quickly become unaffordable or result in a downward spiral of repeated refinances that drain equity and increase the risk of foreclosure.

Mortgages are complex financial transactions, and the most important one that most families enter. If brokers and lenders are permitted to market high-risk products without considering the homeowner's ability to repay, there are serious consequences for individual families and ultimately, entire neighborhoods.

We respectfully submit that state regulators *can* and *should* address this problem now by <u>requiring</u> that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan, and also by <u>strengthening</u> <u>enforcement</u> against unscrupulous actors who convince homeowners to accept these loans that set homeowners up to fail.

CRL applauds the Senate Banking committee for holding this hearing. But urgent action in California is needed to:

- Require all relevant California regulators adopt the CSBS/AARMR guidance covering all California mortgage lenders and brokers;

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[26] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

- Make the guidance applicable to subprime hybrid 2/28 and 3/27ARMs as well as other, non-traditional mortgage products.

- Include in the guidance the requirement that lenders document all sources of income and escrow for property taxes and insurance, and include these payments in the calculation of the borrower's ability to repay the loan.

- Put mortgage lenders and brokers on notice that failure to follow the guidance will be deemed a violation of relevant California mortgage and real estate law and will result in enforcement measures by California regulators.

Senator Michael J. Machado
Chair, Senate Banking, Finance & Insurance Committee
State Capitol, Room 5066
Sacramento, CA 95814

Re: *Testimony on exotic mortgages*

Dear Chairman Machado,

The California Reinvestment Coalition (CRC) thanks the chair and the committee for addressing the important issue of nontraditional loans, as these products are being aggressively sold and are having a huge impact on home ownership and home preservation in California. CRC hopes that the Federal Regulatory Guidance ("Guidance") can be clarified, strengthened, and applied to California licensees that might not otherwise be covered. To do so would be to better enable Californians to build and maintain home equity, and to establish stronger integrity in the state's lending market.

The California Reinvestment Coalition is a nonprofit membership organization of two hundred forty (240) nonprofit organizations and public agencies across the state of California. We work with community-based organizations to promote the economic revitalization of California's low-income communities and communities of color. CRC promotes increased access to credit for affordable housing and community economic development, and to financial services for these communities. Over the last few years, CRC has focused increased attention on fighting predatory financial practices in California.

In short, current protections are inadequate to protect consumers in California from abusive lending practices in the subprime and nontraditional mortgage markets. The state can and must take action to blunt the impact of these practices which, at best, rob unsuspecting consumers of millions of dollars in valuable home equity and, at worst, propel homeowners into a downward spiral towards default and foreclosure.

We hope at a minimum, the Legislature will apply the guidance to state licensees, and clarify that the guidance applies to all loans with low initial teaser rates. But we hope the Legislature will go further to protect California consumers from abusive lending practices that will lead to foreclosure and the loss of wealth in our state.

CRC notes four main problems impacting consumers in the mortgage market.

1. **Option ARMs, Interest Only and stated income loans have been sold aggressively to consumers for whom these products are not suitable, causing great harm to consumers and their neighborhoods.**

   - Our counseling agency and legal service members report more borrowers are coming to them with loans they should never have been given.
   - Interest Only, option ARM and stated income loans are being sold to borrowers who cannot afford homeownership and who do not understand their loan terms.
   - With hundreds of billions of dollars in loans scheduled to reset in the next few years, we know many will not be able to make their increasing mortgage payments.
   - As their payments dramatically increase, these borrowers will have a difficult time qualifying for refinance loans, and those who can refinance will face steep prepayment penalties which, in California, translate into thousands of dollars of lost equity.
   - Stated income loans are a recipe for abuse, where brokers inflate the incomes of unsuspecting borrowers. We also believe that many borrowers can provide documentation but are stuck with higher cost, stated income loans nonetheless.
   - CRC analysis shows that perhaps 50% of subprime loans made in the state are from lenders currently not subject to the federal guidance.

2. **Consumers don't understand these complex loan transactions.**

   - These products were designed for sophisticated borrowers, but are being sold as affordability products to borrowers who are new to the market.
   - Often brokers discuss loan terms in a borrower's native, non English language, but the documents are English only, in many cases with different terms than those discussed.

3. **Steering and overcharging on nontraditional and subprime loans is impacting California consumers, especially borrowers of color**. In CRC's recent study "Who Really Gets Higher Cost Home Loans," we found that minority neighborhoods in California were nearly four times as likely to get higher cost home purchase loans, and we estimated that people of color in the state are paying over $1 billion more per year as a result of higher priced home loans.

   Outgoing New York Attorney General Elliot Spitzer recently settled a fair lending case with a major lender, based on initial home lending disparities that are smaller than what we see in California.

   Additionally, a recent report by the Consumer Federation of America revealed that African American and Latino borrowers were more likely to receive option ARM loans.

4. **The secondary market has facilitated the growth of abusive lending**. Why do bad loans get made? A recent NY Times article quoted William Dallas, the owner of the now defunct Ownit Mortgage Solutions, as placing the blame for Ownit's demise on investors and Wall Street saying they encouraged Ownit and other subprime lenders to make riskier loans. "The market is paying me to do a no-income verification loan more than it is paying me to do the full documentation loans. What would you do?" Even the federal bank regulators in their deliberations on the federal guidance identified and recognized the important role the secondary market plays in loan origination.

CRC proposes the following solutions to help mitigate these four key problems:

1. **Adopt and clarify the Guidance**. Adopt the guidance and clarify that it applies to all loans with low initial teaser rates.

2. **Promote and Fund Home Loan Counseling, and Ensure Key Loan Documents are in the Language of Negotiation.**

   - Require, promote, and fund home loan counseling for all nontraditional loans and high cost home loans. The home loan process is too complex for most consumers to understand. Counseling can level the playing field where loan sellers are pushing questionable products on unsuspecting consumers. While we would urge further regulation of abusive practices, encouraging borrowers to seek counseling is probably the quickest was to ensure consumers don't become victimized.
   - Importantly, the state should create a funding mechanism to build the capacity of certified home loan counseling agencies to serve all consumers and communities.
   - Promote informed consumer choice by requiring key loan documents to be written in the same language as the language in which the negotiation was conducted. This is a big problem in our state. Contracts are negotiated in one language, but the loan docs are all in English, and with less favorable terms than the consumer understood. California Civil Code §1632 provides a good starting point, though it is not clear if the law is being honored by lenders or whether it covers all relevant transactions.

3. **Bolster the state's anti Predatory Lending law and urge state enforcement of fair lending laws.**

   - Revisit the anti Predatory Lending, Covered Loan law to cover more loans and expand consumer protections, including those provisions designed to protect against overcharging and steering borrowers to more expensive products. CRC would suggest amending the state law to:

    - Include Yield Spread Premiums and prepayment penalties in the points and fees calculation. These provisions are not in the borrower's interest in many cases. We believe the Legislature intended at the time for Yield Spread Premiums to be included in the points and fees calculation.
    - Prohibit prepayment penalties that extend beyond the initial interest rate of the loan. Brokers will often tell borrowers not to worry if their documents show different terms than what was negotiated, because the borrower can refinance later, virtually guaranteeing the borrower will lose thousands of dollars in prepayment penalties. The main problem with nontraditional loans is that consumers don't understand who they work. Consumers should not be penalized for being tricked into an unsuitable loan by having to incur a prepayment penalty to refinance when their rates go up.
    - Lower the thresholds so the rate trigger is set at 6% above Treasury, and the points and fees trigger is set at 5%. The existing thresholds are unreasonable given the high housing costs in California.
    - Include assignee liability language. Everyone realizes that the secondary market needs to be accountable or predatory lending will continue to thrive.
- Additionally, we urge the Legislature to clarify that the legislation was never intended to preempt local governments from passing ordinances designed to address local problems.
- Also, we note approvingly the actions of outgoing New York Attorney General Elliot Spitzer in bringing a fair lending case against Countrywide, based on home lending disparities that were much smaller than what see in California for the industry as a whole.

4. **Extend assignee liability in legislation and use the power of the purse (State funds, CalPRS, CalSTRS) to have the state cease doing business with financial institutions that are facilitating predatory lending.**

The mortgage market is currently broken. Consumers need help from our policy makers. We urge you to take action to stop abusive loan practices.

Thank you for your consideration of these views.

Very Truly Yours,

Kevin Stein
California Reinvestment Coalition

The following packet highlights the existing problems in the banking/ lending industry, and the solutions for them.

The problems that are addressed in the following packet are;

Problem #1 Stated income loans
Problem #2 Negatively amortized loans
Problem #3 Residential home appraisals and how they are ordered
Problem #4 The industry is set up to offer higher fee and higher interest rate loans to the less educated
Problem #5 The language in which the terms are negotiated.
Problem #6 Consumers choose a certain loan product because they will get a trip or a prize.
Problem #7 Enforcement
Problem #8 Current employment environment
Problem #9 Prepayment penalties

If you would like to speak more about the above topics, or other mortgage and lending issues please call 650-716-8187.

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Existing problems in the banking/ lending industry, and the solutions for them.

Problem #1 Stated income loans;

- Stated income loans are associated with fraud, whether it is to increase someone's income, extend the length of employment or increase the amount of money that is showed in someone's bank account.
- These loans are popular with tax cheats as well. A stated income loan is a tool used if someone is not reporting their true income to the California and Federal governments.
- Stated income loans are used to understate a person income so that the bank can obtain a CRA credit.
- Because stated income loans have become immensely popular in recent years, loan officers in the industry have convinced themselves that a little white lie is no big deal. Sometimes that little white lie can be doubling someone's income on their application.

Solutions for #1

- *Ban stated income loans (still allowing no income loans and no ratio loans, there is no fraud associated with them).*
- *Give the California franchise tax board access to all loans for auditing purposes. This should scare many self employed people from committing both tax and mortgage fraud.*
- *Not allow CRA credit to be given on stated income loans. Some lenders are encouraging mortgage brokers and loan officers to state a lower income for some borrowers so the bank can receive CRA credit. This practice rewards the loan officer with a high commission or Yield Spread Premium (YSP.)*

Problem #2 Negatively amortized loans

- Negatively amortized loans are being sold to consumers in increasing large volumes. These loans are often not in the client's best interest.
- People are getting these loans without full knowledge or awareness of the terms.
- Greedy loan officers and mortgage brokers are taking full advantage by telling the consumer only about the low pay rate, and then giving the consumer a large note rate associated with HUGE commissions.

Solutions for #2

- *In an advertisement for a loan that could possibly be negatively amortized, require that the same size font as the minimum monthly payments be used to disclose the fully amortized monthly payment. Show lowest monthly option payment and highest monthly payment option. (on print media, mail and internet.)*
-*Mandatory education for all neg am or option arm loans, written similar to the bill that Senator Joe Simitian (Palo Alto) wrote into law about reverse mortgages.*
- *Limit YSP to 1 point to go in the MB's pocket for a neg am/ option arm loan. This would allow for more than 1 YSP to be paid out if the amount over 1 point only goes to paying closing costs for the consumer.*

Problem #3 The appraisals

- Many mortgage fraud cases require an inflated appraisal.
- The loan officer or mortgage broker is the one that orders the appraiser.
- Appraisers complain of;
    - The withholding of business if they refuse to inflate values
    - The withholding of business if they refuse to guarantee a predetermined value
    - The withholding of business if they refuse to ignore deficiencies in the property
    - Refusing to pay for an appraisal that does not give the MB the value they wanted
    - Black listing of honest appraiser in order to use "rubber stamp" appraisers, ect
- Imagine if a contractor could cherry pick their favorite home building inspector.

Solutions for #3

- *Require all appraisals ordered through a 3rd party, preventing MB's and loan officers from talking and coercing the appraisers into obtaining a predetermined value.*

Problem #4 The industry is set up to offer higher fee and higher interest rate loans to minorities and the less educated.

- A mortgage broker or loan officer has the power in California to make a 6% commission on the loan amount. This means that a loan officer can make $30,000 on just one deal with a loan balance of $500,000. The loan officer has the power to choose to make 1 point one day, and then 3 points the next. This invites for discriminatory practices; praying on minorities, the less educated, and the elderly.

Solutions for #4

- Limit YSP to 1 point to go in the MB's pocket. (possibly only for loan amounts over $175,000) This would allow for more than 1 YSP to be paid out if the amount over 1 point goes to pay closing costs for the consumer. Lately there are banking promoting 3.5 points as a Yield Spread Premium on neg am loans so the note rate is extremely high, but all the consumer cares about is the low teaser rate.

Problem #5 The language in which the terms are negotiated.

- The language in which the terms are negotiated and the language in which the loan documents are printed are not always the same. Leading for certain people to use a common language asa tool for building trust within the relationship. Only to have the terms negotiated unknowingly changed on the loan documents.

Solutions for #5

- Require that the loan documents get printed in the same language as the terms were negotiated.

Problem #6 Consumers choose a certain loan product because they will get a trip or a prize.

- Some mortgage brokers will advertise that if the consumer works with them that they will get a dream vacation to Hawaii or a cruise.
- The consumers end up paying for the trip over the long run with a loan with higher fees and a higher rate.
- If someone is going to a mortgage broker for a dream vacation that they otherwise could not afford than they probably are going to get ripped off and be steered into a loan they could not afford, or steered into the wrong loan for them.

Solutions for #6

-Banning a rebate from loan officers and mortgage brokers to the consumer. (Mirroring the insurance industry's ban on rebating)

Problem #7 Enforcement

- Important information is hard for law enforcement agencies to obtain to detect mortgage fraud schemes.
- Often times a broker will over look the need to employ someone who is licensed.
- Sometimes a broker will over look the need for a license as long as they are "working" on earning the license.

Solutions for #7

- Part 1: Requiring the escrow company of a real estate transaction to collect the following information and to give that information to the county recorders office; appraiser's name, notary, real estate agent, and mortgage broker or loan officer name, and price incentives (like closing costs, and cash back to the buyer) with all refinances and real estate purchases.

Part 2: Require that the county recorder's office record and make public the appraiser's name, notary, real estate agent, and mortgage broker or loan officer name, and price incentives (like closing costs, and cash back to the buyer) with all refinances and real estate purchases.

- Making it illegal for a loan officer to notarize or be the appraiser in any one deal.

- Make it illegal for the real estate agent to be the loan officer for any one deal, except if it is for them self.

Problem #8 Current employment environment

- The mortgage industry is saturated with inexperienced loan officers being paid solely on commission.
- With the mortgage industry winding down from record producing years (2003, 2004, and 2005) loan officers and telemarketers will be more enticed to commit fraud and become less ethical if they are paid 100% on commission.

Solutions for #8

- Limit the amount of salespersons that a Real Estate broker can have under his or hers broker's license. Right now the number is unlimited, it should be closer to 50... 75 MAX! There is one instance in southern California where 2 brokers have over 4200 salesmen to look out after.

- Dissolve the practice of having call-centers where the telemarketer is paid only on commission, bypassing minimum wage laws.

- Require more stringent license and education requirements for all mortgage professionals, not just the brokers. I.e. loan officers working for banks and direct lenders.

- Up the fine to $25,000 and loss of someone's real estate brokers license if they compensate a loan officer not licensed by the department of real estate.

Full Document Loans

Possible documentation that might be collected for underwriting purposes to classify a loan as full documentation are listed but not limited to the following;

-W-2's
-Paycheck stubs
-Tax returns
-Quarterly statements for self employed persons.

A New form of full documentation accepted by some banks:
-Deposited checks for 2 or 3 months.

No-Doc, Low-Doc, Lite-Doc

Stated income-
An income is put down on the application, but the income amount is not verified. The income is simply believed.
Verifiable information with a stated income loans can include;

Verification of employment
Job title,
Dates of employment

No Ratio-
The income portion of the application is left blank. There is no fraud associated with these loans. (verification of employment might be checked)

NINA-
No income, and no assets are disclosed. The income portion and asset portion (i.e. checking and savings accounts) of the application is left blank. There is no fraud associated with these loans. (verification of employment might be checked)

NINJA-
No income, no job no assets.
A borrower does not put on the application any income or assets or employment inforation. The individual's employer is not called to verify any employment.

There is no fraud associated with a No Ratio, NINA, or NINJA since the income and or asset section of the application is left blank.

Only with a stated income loan is there fraud invited into the loan product since the bank is asking for an income amount to be "stated" on the application but not verified.

4. Is the broker properly supervising?

Correct Procedure:

A broker shall exercise reasonable supervision over the activities of his or her salespersons. Reasonable supervision includes, as appropriate, the establishment of policies, rules, procedures and systems to review, oversee, inspect and manage:

1. Transactions requiring a real estate license.

2. Documents which may have a material effect upon the rights or obligations of a party to the transaction.

3. Filing, storage and maintenance of such documents.

4. The handling of trust funds.

5. Advertising of any service for which a license is required.

6. Familiarizing salespersons with the requirements of federal and state laws relating to the prohibition of discrimination.

7. Regular and consistent reports of licensed activities of salespersons.

The form and extent of such policies, rules, procedures and systems shall take into consideration the number of salespersons employed and the number and location of branch offices.

A broker shall establish a system for monitoring compliance with such policies, rules, procedures and systems. A broker may use the services of brokers and salespersons to assist in administering the provisions of this section so long as the broker does not relinquish overall responsibility for supervision of the acts of salespersons licensed to the broker.

Reference:
Real Estate Law Book, Regulation 2725

Solution;

- Limit the amount of salespersons that a Real Estate broker can have under his or hers broker's license. Right now the number is unlimited, it should be closer to 50… 75 MAX! **There is one instance in southern California where 2 brokers have over 4200 salesmen to look out after.**